UNITED STATES OF AMERICA
BEFORE THE
FEDERAL ENERGY REGULATORY COMMISSION

San Diego Gas & Electric Company	Docket No. EL00-95-031
Investigation of Practices of the California Independent System Operator and the California Power Exchange	Docket Nos. EL00-98-030 EL00-98-033
California Independent System Operator Corporation	Docket Nos. RT01-85-000 RT01-85-001
Investigation of Wholesale Rates	Docket Nos. EL01-68-000 EL01-68-001

REQUEST FOR REHEARING BY THE CALIFORNIA ELECTRICITY OVERSIGHT BOARD OF THE JUNE 19, 2001, ORDER

Pursuant to Rule 713 of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.713 (2000), and Section 313 of the Federal Power Act ("FPA"), 16 U.S.C. § 8251, the California Electricity Oversight Board ("CEOB") hereby requests rehearing of the Commission's June 19, 2001, *Order on Rehearing of Monitoring and Mitigation Plan for the California Wholesale Electric Markets, Establishing West-Wide Mitigation, and Establishing Settlement Conference,* 95 FERC ¶ 61,418 (2001) ("June 19 Order").

I.

SPECIFICATION OF ERROR

The June 19 Order is in error in the following respects:

1. The imposition of a ten percent surcharge on the market-clearing price paid to generators for all sales through markets administered by the California Independent System Operator Corporation ("CAISO") is

arbitrary and capricious and internally inconsistent with prior Commission directives.

2. The failure to apply to non-reserve deficiency hours a marginal cost proxy price methodology similar to that utilized in calculating the market-clearing price during reserve deficiency hours is arbitrary and capricious and contrary to the FPA's mandate that wholesale electric prices during non-reserve deficiency hours be just and reasonable.

3. The Commission exceeds its jurisdiction to the extent the must-offer obligation operates to modify or abrogate the firm capacity obligations of qualifying facilities ("QF") under their contracts with California investor owned utilities ("IOU").

4. The determination to permit suppliers to justify each transaction above the mitigated price is arbitrary and capricious and contrary to law, permits suppliers to manipulate their purported costs, and fails to ensure that wholesale electric prices are just and reasonable.

5. The Commission's continued refusal to disclose bid justification data to the CEOB and other public entities is contrary to law and violates due process.

II.

THE IMPOSITION OF A 10% CREDIT SURCHARGE IS ARBITRARY AND CAPRICIOUS AND AN ABUSE OF DISCRETION

The June 19 Order "instruct[s] the ISO to add ten percent to the market clearing price paid to generators for all prospective sales in its markets to reflect credit uncertainty."[1] The purported justification for this surcharge - credit uncertainty - no longer exists. All material credit risks related to CAISO markets have been resolved through the combination of Commission orders imposing creditworthiness standards and the willingness of the California Department of Water Resources ("DWR") to act as a counterparty for CAISO energy transactions. Thus, the Commission's insistence on the ten percent adder is arbitrary and capricious, inherently contradictory to earlier orders on creditworthiness, and simply imposes an unjustified and unnecessary penalty on California consumers.

The Commission has repeatedly ordered the CAISO to ensure that generators enjoy reasonable assurance of payment for energy supplied to its markets. Beginning on February 14, 2001, in response to proposed amendments to the CAISO Tariff, the Commission refused to waive creditworthiness requirements for transactions to supply customers of California's IOUs involving third-party generators.[2] The February 14 Order provided, however, that the Commission would allow the CAISO to excuse the IOUs from posting security for third-party transactions if appropriate credit-support arrangements were made. The February 14 Order implicitly acknowledged that purchases by the DWR provided sufficient credit support. On April 6, 2001, the Commission clarified that its requirement for a creditworthy counterparty applied to all power supplied to serve IOU load, including real-time transactions.[3] On May 25, 2001,

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[1] June 19 Order, slip. op. at p. 35.

[2] *Order Addressing Creditworthiness Tariff Provisions Proposed by the California Independent System Operator Corporation*, 94 FERC ¶ 61,132 (2001) ("February 14 Order").

[3] *Order Granting Motion,* 95 FERC ¶ 61,026 (2001) ("April 6 Order")

in the context of a request for clarification of the April 26 Mitigation Order, the Commission stated:

> We have previously ruled that generators are entitled to assurances of payment for all energy they provide through the ISO and have directed the ISO to ensure the presence of a creditworthy counterparty for all power that any third-party suppliers provide to PG&E and SoCal Edison. These orders cover all third-party generators for all transactions through the ISO. Therefore, as of May 29, 2001, we expect the ISO to ensure the presence of a creditworthy buyer for all transactions made with all generators who offer power in compliance with the must-offer requirement in the Mitigation Plan.[4]

Finally, the Commission confirmed on June 13, 2001, the comprehensive scope of its earlier orders by denying requests for rehearing of the April 6 Order.[5]

The CAISO has, and is, complying with the Commission's directives and has so advised market participants in its April 13 and May 25, 2001 market notices.[6] In its May 25, 2001 market notice, the CAISO informed market participants that, "unless the ISO can provide reasonable assurances that a party meeting the ISO's credit requirements will support a specific transaction, the ISO will not enter into the transaction with respect to any resource." The DWR has assumed the role of purchasing electricity to meet the "net short" demand of the IOUs. The DWR is a creditworthy purchaser. Other wholesale

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4 *Order Providing Clarification and Preliminary Guidance on Mitigation and Monitoring Plan for the California Wholesale Electric Markets*, 95 FERC ¶ 61,275, slip. op. at p. 6 (2001) ("May 25 Order"). See also, *Order Denying Rehearing*, 95 FERC ¶ 61,951 (July 12, 2001).

5 *Order Denying Rehearing of California ISO Creditworthiness Order,* 95 FERC ¶ 61,391 (2001) ("June 13 Order").

6 Copies of the CAISO's April 13 and May 25, 2001, market notices are attached as Exhibits A and B, respectively, to the Answer of the California Independent System Operator Corporation to Motion for Enforcement of the Orders of the Federal Energy Regulatory Commission of Southern California Edison Company, Docket Nos. ER01-889-005, et al. (June 22, 2001) ("CAISO Answer"). The CEOB respectfully incorporates fully herein by reference the CAISO Answer, pursuant to Rule 508(c) of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.508(c).

electricity purchasers, such as municipal utilities, also have been, and continue to be, creditworthy. Indeed, the CAISO has confirmed that it "has not entered into any real time transaction unless a creditworthy party has provided assurance of payment."[7] The only evidence before the Commission, therefore, establishes full CAISO compliance with the creditworthiness orders and the concomitant absence of "credit uncertainty."

Given the successful elimination of credit risk for transactions in CAISO markets, the creditworthiness orders and the ten percent surcharge are redundant as well as inherently inconsistent. Both attempt to eliminate the effects on suppliers of the financial crisis facing the California IOUs. However, the simultaneous application of both remedial measures operates to inappropriately compensate generators for credit risk that has been eliminated. The June 19 Order endows generators with additional profit, despite the Commission's various orders that protect them from the very credit risk that justifies the surcharge's existence. Only if the Commission rescinded its creditworthiness orders would the credit risks associated with the CAISO markets conceivably support the monetary surcharge imposed by the June 19 Order. Accordingly, no justification exists for the ten percent surcharge and its implementation is arbitrary and capricious and cannot be supported by the record compiled in this proceeding.

III.

THE FAILURE TO EMPLOY A MARGINAL COST METHODOLOGY TO MITIGATE PRICES IN NON-RESERVE DEFICIENCY HOURS IS ARBITRARY AND CAPRICIOUS

The stated goal of the June 19 Order is to expand "the market monitoring and mitigation plan to produce spot market prices in all hours that are just and reasonable and

7 Declaration of James W. Detmers, attached as Exhibit D to CAISO Answer.

emulate those that would be produced in a competitive market."[8] The Commission recognizes that a "model" competitive market will clear at the marginal cost of the least efficient unit dispatched.

> Competitive markets clear at a single price, which is effectively set by the marginal cost of the last unit produced. All more efficient units will receive the same price, which creates an incentive for firms to increase their efficiency. Therefore, using the marginal cost of the least efficient unit dispatched best replicates prices in a competitive market.[9]

The methodology employed by the Commission in the June 19 Order unreasonably ignores its own theoretical underpinnings and, therefore, is arbitrary and capricious. Rather than rely on marginal cost bidding to achieve just and reasonable prices in all hours, the Commission has limited the use of marginal cost bidding to periods of reserve deficiency and thereby leaves the door open for price abuses in non-reserve deficiency hours. During reserve emergencies, the CAISO is instructed to dispatch units not on the basis of generator bids, but on the basis of a proxy price calculated to reflect each unit's marginal costs (i.e., heat rate, gas costs and O&M costs). The proxy price of the market-clearing unit will be paid to all sellers that are dispatched. This methodology is consistent with the Commission's formulation of a competitive market and reduces sellers' ability to manipulate the price.

In contrast, the June 19 Order sets the maximum mitigated price for non-reserve deficiency conditions at 85% of highest priced hour of the last Stage 1 emergency. During non-emergency hours, sellers will be dispatched as bid. If the market clears below the cap, then sellers will be paid the market-clearing price. If the market does not

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8 June 19 Order, slip. op. at p. 24.

9 June 19 Order, slip. op. at p. 28.

clear at or below the cap, sellers will be paid the capped price, i.e. 85% of the highest price hour during the most recent Stage 1 emergency.

The difference in pricing methodologies between emergency and non-emergency hours encourages price exploitation during non-reserve deficiency hours. For example, assume that during a Stage 1 emergency condition, when demand is high, an inefficient generation unit with a heat rate of 20,000 sets the market-clearing emergency proxy price at $200/MWh (this assumes a natural gas spot price of $10/MBTU for this example). This would set a maximum mitigated non-emergency price of $170/MWh (85% of $200/MWh). The Commission itself recognizes that this cap will far exceed marginal costs of those generation units that would set the clearing price during non-reserve deficiency hours and therefore will not approximate a competitive market.[10] Since it has been established that market power exists during non-emergency conditions, sellers will have an incentive and, more importantly, the ability to manipulate the price by collectively bidding at the cap. The result is a complete uncoupling of the clearing price from any competitive market benchmark. Thus, only by applying a pricing methodology similar to emergency hours in all hours, can the Commission ensure just and reasonable prices by eliminating the price inflation that arises from the exercise of market power during non-emergency conditions.

The Commission has attempted to rationalize the windfall to generators during non-reserve deficiency hours as a necessary means to "induce new supply."[11] This rationale rings hollow. The record is devoid of any analysis by the Commission

[10] June 19 Order, slip. op. at p. 5.

[11] *Id.*

regarding the appropriate level of return on capital needed to spur additional investment in California's electricity infrastructure. The Commission's selection of 85% of the Stage 1 emergency clearing price is wholly arbitrary. Indeed, the Commission has admitted that "regulators are ill-equipped to replicate the premiums which a functioning market assigns to a diminishing supply."[12] No formulation of an artificial "premium" is necessary. As recognized by the Commission, the supply scarcity in California should allow efficient producers to receive compensation well in excess of marginal costs. If supply is low, it will be necessary to dispatch an inefficient unit such that the clearing price will reward efficient producers. Thus, Commission's purported justification for its non-emergency hours mitigation methodology is unsupported by the record and the Commission's own reasoning.[13]

IV.

THE COMMISSION MUST CLARIFY THAT THE MUST-OFFER OBLIGATION DOES NOT GRANT QFs DISCRETION TO WITHHOLD OUTPUT CONTRACTUALLY COMMITTED TO A UTILITY

The June 19 Order reinforces that "[f]or QF facilities, like other generators, the must-offer obligation applies to energy that is available from generation that is not already *contractually committed* or would not violate its contractual obligation to its

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[12] *Id.*

[13] In its request for rehearing of the April 26 Order in this proceeding, the CEOB asserted that the Commission's price mitigation efforts have failed to ensure just and reasonable prices. Consequently, the CEOB argued that the FPA required the Commission institute cost-based ratemaking for the Western Systems Coordinating Council. By arguing in support of a marginal cost proxy methodology for all hours, the CEOB does not abandon, waive or otherwise modify its support for a return to cost-based ratemaking. The Commission's rejection of cost-based ratemaking in the June 19 Order was final and is appropriately challenged through a petition for review in federal court. In contrast, the June 19 Order expanded, for the first time, mitigation to non-reserve deficiency hours and therefore is an appropriate subject for rehearing. Moreover, to the extent subsequently developed evidence demonstrates that the mitigation methodology of the June 19 Order is ineffective to ensure just and reasonable prices, the CEOB reserves the right to augment the record and reassert that the Commission must institute cost-based ratemaking.

thermal host."[14] This statement fully conforms to the Commission's May 16, 2001, *Order Granting Motions for Emergency Relief in Part and Deferring Action on Other Aspects of Motions and Proposed Order Under Section 210(d) Directing Interconnections with Qualifying Facilities and Establishing Further Procedures*, 95 FERC ¶ 61,226 (2001) ("May 16 Order"). The May 16 Order sought to "increase generation supply for the California markets by allowing California QFs to enter into bilateral contracts for the sale of *excess QF power*."[15] In so doing, the Commission "emphasize[d] that the action we are taking herein does not modify or abrogate existing contracts."[16]

Despite the Commission's clear intention to preserve contractual rights under QF contracts, the Commission defined excess QF power without reference to the predicate need for a contractual right to sell to third parties. The May 16 Order defined "excess QF power" as "power above what has been historically sold from a facility to the purchasing utility. A facility's seasonal average output during the two most recent years of operation will define historical output."[17] The CEOB, as well as the California Public Utilities Commission, requested rehearing of the May 16 Order, in part, to clarify that a QF's contractual ability to make excess QF power sales depends in the first instance on the contract language selected by the QF.[18] For example, standard offers 1, 2, 3 and interim

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14 June 19 Order, slip. op. at p. 15 [emphasis added].

15 *Order Granting Motions for Emergency Relief in Part and Deferring Action on Other Aspects of Motions and Proposed Order Under Section 210(d) Directing Interconnections with Qualifying Facilities and Establishing Further Procedures,* 95 FERC ¶ 61,226 (2001) ("May 16 Order"), slip. op. at p. 3 [emphasis added].

16 *Id.* at p. 12.

17 *Id.* at p. 2, fn. 1.

18 The CEOB respectfully incorporates fully herein by reference, pursuant to Rule 508(c) of the Commission's Rules of Practice and Procedure, 18 C.F.R. § 385.508(c), the following documents: (1) Request for Rehearing by the California Electricity Oversight Board of the May 16, 2001, Order Granting

standard offer 4 all contain pricing provisions that enable a QF to choose either a "net energy output" energy sales option or a "surplus energy output" energy sales option.[19] The net energy option requires a QF to sell all of its generation to the utility.[20] Simply put, no excess power, as defined by the Commission, exists under the contracts.

This omission of any reference to the QF contract in the definition of excess QF power creates the unjustified impression that all power generated above the facility's seasonal average can be sold to third parties. The June 19 Order perpetuates this fallacy by stating that "a QF with capacity committed to a utility is, therefore, subject to the must-offer obligation if it chooses not to sell its maximum output to the utility."[21] Again, this statement ignores that many QFs do not possess the contractual authority to unilaterally "choose" not to sell its maximum power to a utility in order to participate in the CAISO's open markets. The Commission should, therefore, clarify on rehearing that a QF will be subject to the must-offer obligation only to the extent the QF's contract permits third-party sales. [22]

Motions for Emergency Relief, Docket Nos. EL00-95-035, et al. (June 14, 2001) and (2) Brief and Motion for Clarification of the Public Utilities Commission of the State of California, Docket Nos. EL00-95-035, et al. (May 30, 2001).

[19] Standard offers refer to various standard offer contracts adopted by the California Public Utilities Commission for the purchase and sale of QF power. For the origin of standard offers see 8 CPUC2d 20 (1982), 10 CPUC2d 553 (1982) and 12 CPUC 604 (1983).

[20] Net energy output is generally the QF's gross output in kilowatt-hours less station use and transformation and transmission losses to the point of delivery into the utility's system.

[21] June 19 Order, slip. op. at p. 15.

[22] On July 16, 2001, the Commission issued an *Order on Rehearing* regarding the May 16 Order. In that order the Commission expressly deferred final resolution of all issues raised on rehearing by the CEOB and the California Public Utilities Commission. It follows that the June 19 Order, issued prior to the *Order on Rehearing*, did not intend to decide whether the definition of excess QF power will be limited by the terms of existing QF contracts or how that issue will effect the capacity subject to the must-offer obligation. The CEOB raises the issues herein out of an abundance of caution, recognizing that considerable overlap exists with those issues to be resolved in the subsequent Commission order referenced in the *Order on Rehearing.*

V.

THE DETERMINATION TO PERMIT SUPPLIERS TO JUSTIFY EACH TRANSACTION ABOVE THE MITIGATED PRICE IS ARBITRARY AND CAPRICIOUS AND CONTRARY TO LAW

The June 19 Order proposes a mitigated price methodology which seeks to mimic workably competitive market conditions. For sellers "dissatisfied" with the mitigated prices, the Commission provides two options:

> They may propose cost-based rates for their entire portfolio of generating facilities in the WSCC in a section 205 filing with cost support including a reasonable rate of return on investment that reflects the unique conditions in California. Alternatively, although we believe the mitigated price to be adequate, sellers can seek to justify each transaction above the mitigated price.[23]

The June 19 Order further makes it clear that generators who seek to justify bids above the mitigated clearing price must "show that their entire gas portfolio justified such a bid."[24]

While this formulation improves significantly over the Commission's prior mitigation orders, opportunities for manipulation remain. The Commission should close these opportunities by providing that the sole option for generators dissatisfied with the mitigated price is to file for cost of service rates covering all of their generation units in the WSCC for the duration of the mitigation plan. Since generation owners could be expected to file for cost of service rates only when they anticipated that such rates would, overall, exceed the mitigated price, such a requirement would provide generation owners with the choice to take the higher of the mitigated price or cost of service pricing.

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23 June 19 Order, slip. op. at p. 35.

24 *Id.* at p. 31.

The Commission's discussion in the June 19 Order effectively rebuts claims that generators must have the opportunity to receive prices above the mitigated price on a transaction-by-transaction basis. Such pricing is not, for instance, required to ensure that marginal suppliers recover fixed costs. The Commission observes that many sellers, including most if not all in-state merchant generators "have a portfolio of generating capacity, with units that will be more efficient than the unit setting the market clearing price. Therefore, the amounts earned on the more efficient plants will cover the investment in the marginal plant."[25] In addition, bilateral contracts "provide opportunity for any seller to structure the arrangements necessary to recover its costs."[26] Moreover, "under the FPA and our authorization for market-based rates, sellers are not guaranteed to recover all costs but are provided the opportunity to do so."[27] And, finally, the opportunity to file cost of service rates for the supplier's western generation portfolio provides the opportunity to recover fixed costs.

Moreover, providing suppliers with the opportunity to justify each transaction invites manipulation of costs. As the June 19 Order makes clear, any such justification will be based on the assertion that a generator's actual fuel costs exceed the gas price used to set the mitigated price. However, virtually all California generating companies purchase gas used to fuel their electricity sales from a marketing affiliate. Such inter-affiliate dealing permits generators to overstate their production costs and seek to justify its bidding practices based on natural gas payments made to its affiliate. Even the Commission's requirement that any attempted justification be premised on a company-

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25 *Id.* at p. 34.

26 *Id.* at p. 34.

27 *Id.*

wide gas portfolio cannot entirely eliminate the opportunities for affiliate dealing to overstate costs and thus prices.

The June 19 Order correctly notes that sellers with market-based rates are not guaranteed recovery of all costs, and provides sellers who desire more certainty with the opportunity to file for cost-of-service rates for their generation portfolios in the WSCC. The FPA does not require the Commission to offer more. To the contrary, because of the opportunities for abuse of transaction-by-transaction justification, providing this option is inconsistent with the Commission's obligations under the FPA. It should be eliminated.

VI.

THE COMMISSION MUST DISCLOSE COST JUSTIFICATION DATA

As noted, the June 19 Order allows generators to seek justification for transactions above the mitigated price. Only generator submissions that fail to justify the as-bid prices are subject to refunds. Nevertheless, those entities most impacted by the cost of bids above the mitigated proxy price, namely California regulatory agencies representing wholesale purchasers and consumers, are refused any opportunity to review and challenge the sufficiency of the attempted justifications. The Commission in the June 19 Order makes no provision for disclosure of the cost justification data.

The Commission cannot withhold the data on the purported basis of competitive injury to the submitters. In order to do so, the Commission must prove that the submitters: (1) actually face competition, and (2) substantial competitive injury would likely result from disclosure. *National Parks & Conservation Ass'n v. Kleppe*, 547 F.2d at 679 (D.C. Cir. 1976). This test cannot be met. The CEOB's possession of this information (in conjunction with its agreement to treat the information as confidential) could not invoke any risk of competitive injury to the submitters. Neither the CEOB or, for instance, the California Public Utilities Commission, is a market participant or competitor of any supplier. Concerns regarding abuse of trade secret information simply do not apply.

The CEOB has a legitimate public interest in the cost justification data in the area of protection for California's energy consumers and the development of a workably competitive electricity marketplace. The information the CEOB seeks from the Commission pertains to generators' costs of production that affect market prices. Such information has been traditionally available to state regulatory agencies by virtue of utilities operating under cost-based rate methodologies. The fact that sellers now have market-based rate authority from the Commission does not negate the legitimate public interest role of the CEOB and other state agencies to protect consumer interests.

Moreover, in the related context of the Freedom of Information Act, case law holds that an interest in "official information that sheds light on an agency's performance of its statutory duties falls squarely within that statutory purpose" and may be weighed in the balance. *United States Dep't of Justice v. Reporters Comm. For Freedom of the Press*, 489 U.S. 749, 773 (1989). The CEOB's interest in reviewing the cost justification data directly impacts any evaluation of the Commission's performance of its statutory duties. The Commission is required under the FPA to ensure that rates in California's wholesale energy markets are just and reasonable. In part, the purpose of the Commission requiring the cost justification information is to enable Commission review of costs-of-production to determine the justness and reasonableness of those charges and potential refund liability. The review of this information is essential to any check on the authority and performance of the Commission and the failure to facilitate such review violates fundamental due process concepts.

VII.

CONCLUSION

For the reasons set forth above, the CEOB respectfully requests that the Commission issue an order on rehearing that takes the following actions:

1. Eliminate the ten percent surcharge applied to the market-clearing price to be paid to generators for all sales in the CAISO markets.
2. Require calculation of mitigated prices during non-emergency hours by using a marginal cost proxy price in a manner similar to the market-clearing price methodology during emergency hours.
3. Clarify that the must-offer requirement does not modify or abrogate existing obligations under contracts between QFs and IOUs.
4. Eliminate the option for sellers to justify each transaction above the mitigated market-clearing price.

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5. Permit disclosure of cost justification data to state regulatory agencies upon agreement to maintain the confidentiality of the data.

Dated: July 18, 2001

Respectfully submitted,

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CERTIFICATE OF SERVICE

I hereby certify that I have caused the foregoing document to be served on or before July 19, 2001, upon each person designated on the official service list compiled by the Secretary for this proceeding, pursuant to Rule 2010(a) of the Commission's Rules of Practice and Procedure.

Dated at Sacramento, California, this 18th day of July, 2001.

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